USDA Foreign Agricultural Service
GAIN Report
Global Agricultural Information Network

THIS REPORT CONTAINS ASSESSMENTS OF COMMODITY AND TRADE ISSUES MADE BY USDA STAFF AND NOT NECESSARILY STATEMENTS OF OFFICIAL U.S. GOVERNMENT POLICY

Required Report - public distribution

Date: 10/20/2009
GAIN Report Number: NZ9018

New Zealand

DAIRY AND PRODUCTS ANNUAL

New Zealand Dairy Production Reaches Record Level

Approved By:
Laura Scandurra

Prepared By:
David Lee-Jones

Report Highlights:
Fluid milk production for MY 2008/09 is estimated at a record 16.6 million tons, up 9% from last year. Production is forecast to jump another 2.5% in MY 2009/10 hitting an all time high of 17 million tons.

Commodities:
Dairy, Milk, Fluid
Dairy, Dry Whole Milk Powder
Dairy, Milk, Nonfat Dry
Dairy, Cheese
Dairy, Butter

Executive Summary

The dairy sector is New Zealand's top export earner and a key driver of economic growth, accounting for 23% of total merchandise exports and approximately 7.5% of GDP. The dairy processing industry is dominated by Fonterra Cooperative Ltd, the world's largest dairy processor and New Zealand's largest company. Fonterra collects an estimated 92% of the domestic milk supply and controls an estimated 40% of world trade in dairy products.

Fluid milk production for MY 2008/09 is estimated at a record 16.6 million tons. This is a 9.6% increase from last year and slightly higher than the original forecast of 16.4 million tons. A 3.5% increase in cow numbers, coupled with a reasonably good growing season, is the primary driver for the increased fluid milk production.

Looking forward, fluid milk production is forecast to jump 2.5% hitting an all time high of 17 million tons in MY 2009/10. This reflects an additional 105,000 cows (up 2.8%) coming on line as the last of the new dairy farm conversions is completed. Whole milk powder (WMP) production is forecast to reach 800,000 tons in MY 2009/2010. If the forecast 2.5% increase in milk production is achieved, the WMP increase would be considerably higher than the annual trend over the last fifteen years of 28,000 to 30,000 tons per year.

Over the last few years, several new processors have set up shop in New Zealand. For most processors, WMP is still the most profitable commodity to produce and virtually all of the additional processing capacity added over the last five years has been in the form of powder/drier facilities. Under the Dairy Industry Restructuring Act, these processors are eligible to obtain up to 50 million liters of regulated milk at a set price from Fonterra.

In MY 2008/09, New Zealand's dairy product exports fell to US $6.2 billion but were up 6.8% on a volume basis to 1.86 million tons (excluding liquid milk). The United States continues to be New Zealand's largest market accounting for 12% of total dairy exports on a value basis in MY 2008/09. However, New Zealand's dairy exports to China surged in MY 2008/09, up 45%, to US $484 million. Leading exports to China include whole milk powder (WMP), up 75%, and skim milk powder (SMP), up 64%. Total dairy exports to the U.S. market reached US $735 million in MY 2008/09, up from US $632 million the previous year. Leading exports on a value basis are milk protein concentrate (MPC) followed by casein, caseinates, cheese, and fats and oils. MPC exports were up 30% to US $249 million on volume increases of 3,250 tons.

New Zealand is an active participant in the flood of free trade agreements (FTAs) in the Asia region. Agreements include a China FTA implemented on October 1, 2008; an FTA between ten ASEAN countries, Australia and NZ that will be implemented next year; and an FTA with Malaysia that was concluded in June and expected to be ratified later this year. New Zealand has also completed two rounds of negotiations towards a NZ-Korea FTA.

New Zealand passed the Climate Change Response (Emissions Trading) Amendment Act in September 2008. Instead of capping the emissions of industry, the system required the sectors of the economy that produce greenhouse gasses to purchase "emission units" for each ton of gas produced. This not only gave New Zealand the distinction of being the only country in the world to include agriculture in a domestic emissions trading scheme but also raised concerns that the resulting increase in on-farm costs would put the New Zealand agricultural sector at a competitive disadvantage. In September 2009, the Government introduced a bill to amend the emissions trading scheme (ETS). Among other things, the proposed bill revises the entry date for agriculture, which is the single largest source of emissions in New Zealand, to 2015 and specifies a production-based industry average approach. The changes proposed in the bill will make many of the elements of the New Zealand ETS consistent with the proposed Australian Carbon Pollution Reduction Scheme (CPRS), including the method of providing free allocations for emissions-intensive activities. The ETS will also feature a transitional phase that puts a NZ $25 fixed price on carbon until January 1, 2013. This is similar to the price controls that will be in place in Australia.

Fonterra announced a capital restructuring proposal on September 18, 2009. This is Fonterra's second attempt at a capital restructure and is intended to raise some of the capital needed to finance its global expansion objectives. Fonterra's 10,700 shareholders will vote on the proposal on November 18, 2009.

In June, Fonterra announced the results of an 18-month study to measure its carbon footprint. Key findings were that the carbon footprint is 940 grams of CO2 equivalent per liter of liquid milk; around 85% of greenhouse gases are emitted on the farm (59% of these are methane, 17% are carbon dioxide, and 24% are nitrous oxide); and, processing/manufacturing accounts for 10% of total emissions while distribution accounts for 5%.

Fonterra implemented an internet-based auction platform for sales of whole milk powder in July 2008. Over the last three auctions, average prices have climbed 56% after hitting a low in July 2009.

Fluid Milk Production

MY 2008/09

Fluid milk production for MY 2008/09 is estimated at a record 16.6 million tons. This is a 9.6% increase from last year and slightly higher than the original forecast of 16.4 million tons. A 3.5% increase in cow numbers, coupled with a reasonably good growing season, is the primary driver for the increased fluid milk production. The estimate reflects production data published by the Ministry of Agriculture (MAF) in the July 2009 Situation and Outlook for New Zealand Agriculture and Forestry (SONZAF) report. According to the report, a total of 1.395 billion kilograms of milk solids were produced during MY 2008/09.

MAF Farm Monitoring Data		
Region	Percent Change in Annual Milk Production per Farm 1/	Percent Production by Region 2/
Northland	-2%	8.0%
Waikato/Bay of Plenty	7%	41.0%
Taranaki	10%	12.4%
Lower North Island	2%	10.2%
Canterbury	-2%	15.5%
Southland	4%	11.9%
Westland	1%	1.0%

1/ Average per farm. August 2009 year compared to August 2008 year.

2/ Percentages based on regional cow numbers in the 2008 Livestock Improvement Corporation (LIC) survey.

The drop in production in both Northland and Canterbury is weather related. Northland experienced a cold, wet winter followed by a cold, wet spring. Canterbury suffered extreme weather shifts - a wet, cold spring followed by a dry summer. While per farm production fell in Canterbury, total production across the region was up due to an increase in the number of farms.

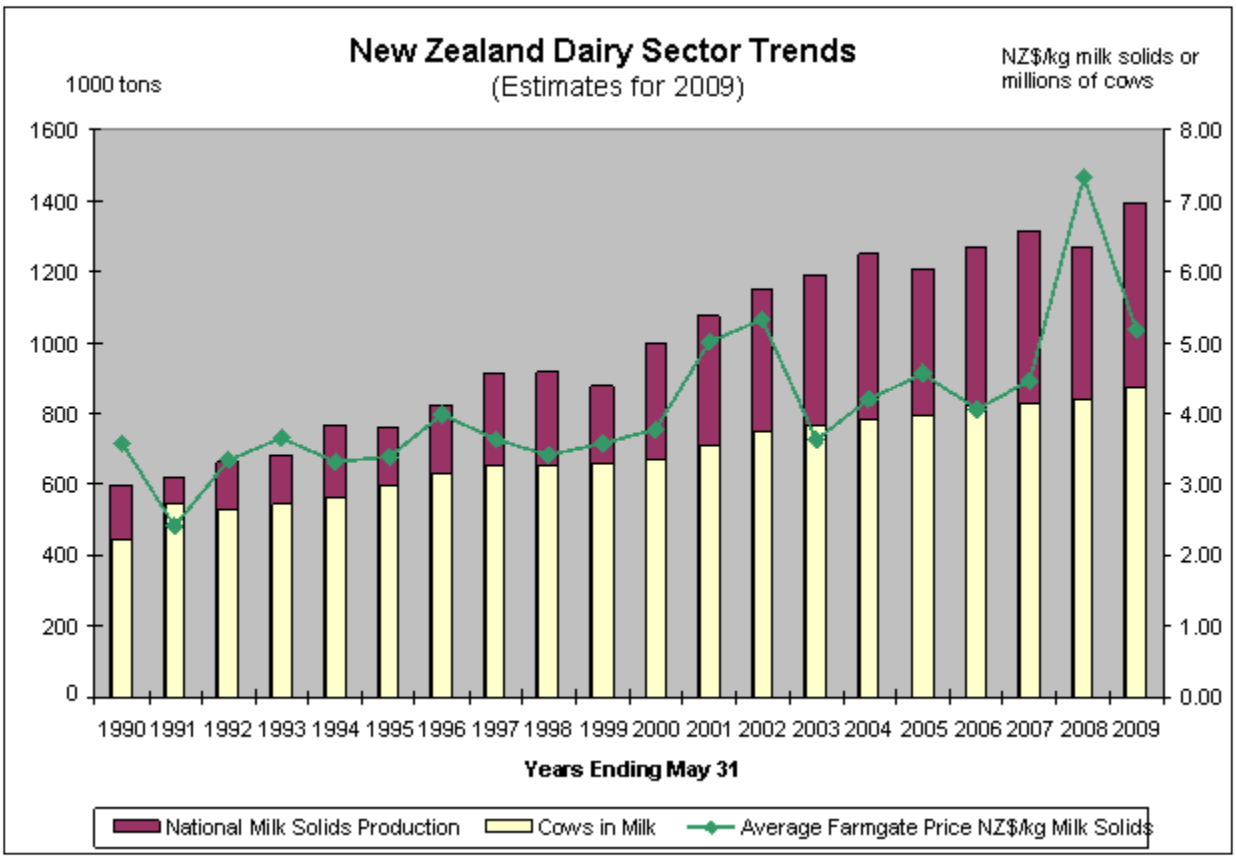
The payout price for the 2008-09 season fell from an average NZ $7.32 (per kilogram of milk solids) last year to just over $5 per kg as detailed below.

Payout Prices by NZ Dairy Cooperatives		
	Payout 2008/09	Forecast Payout 2009/10
Fonterra	NZ $5.20	NZ $5.10
Tatua	NZ $5.38	n/a
Westland	NZ $4.50	n/a

MY 2009/10

Looking forward, fluid milk production is forecast to jump 2.5% hitting an all time high of 17 million tons in MY 2009/10. In making this forecast, post has taken into account other estimates, including a MAF survey of farmers that puts the increase at 3%, a SONZAF report that pegs the increase at 3.85%, and opinions of industry experts that suggest a more modest increase of approximately 2%. Post's forecast is partly based on livestock estimates published by Meat and Wood New Zealand (M&WNZ) and MAF. As the last of the new dairy farm conversions have become fully stocked, M&WNZ estimates indicate that an additional 105,000 cows (up 2.8%) will be milked during the 2009/10 season. These cows are expected to produce, on average, 330 kilograms of milk solids, which supports the forecast 2.5% increase in fluid milk production.

In making this forecast, post has assumed average seasonal climatic conditions. In New Zealand, cows are calved at the onset of spring and typically milked for 250 to 300 days before being dried off for winter. They are fed predominantly outside on pasture. In 2009, after an early and difficult southern hemisphere winter, the main dairy production areas, especially on the North Island, battled with low pasture levels and below average cow condition. However, the spring has been exceptional for pasture growth with the exception of the first two weeks of October (low temperatures, rain and some snow). On the South Island, total fluid milk production at the end of September was reportedly running as much as 8% ahead of the previous year, reflecting both good pasture growth and cow condition.



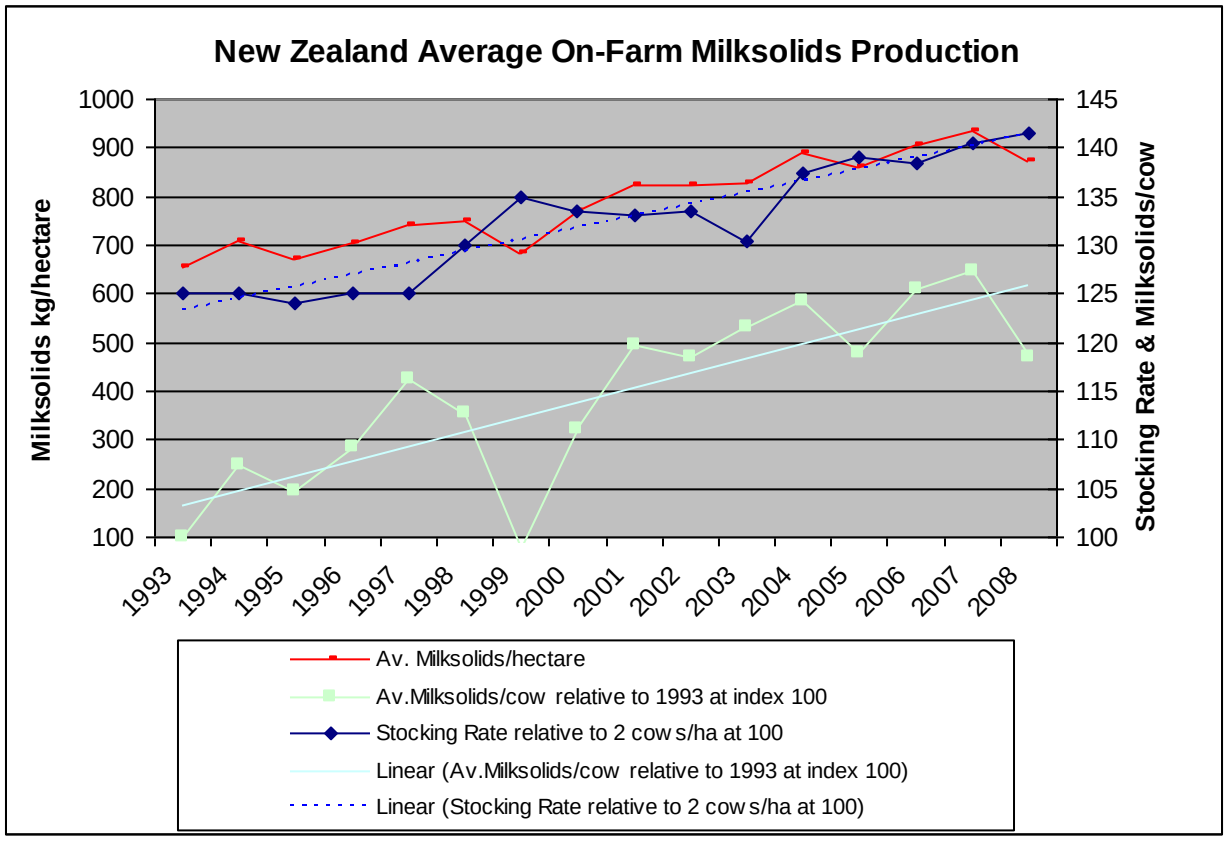
Source: DairyNZ, StatsNZ, MAF

Going forward, it is unclear how the drop in the price paid to farmers for fluid milk, the so-called payout price, will impact on production. Although payout prices have fallen between 30 and 35%, on-farm expenditures have not fallen as quickly. According to MAF and Dairy NZ estimates, on-farm costs have declined between just 8 and 12%. For many farmers, cash flow problems are compounded by high debt levels incurred in anticipation of payout levels in the NZ $7.00 range. The current economic climate has resulted in many farmers re-evaluating their on-farm strategies, with many looking to cut costs in staffing, repairs and maintenance, fertilizer, supplementary feed, and machinery/other asset purchases. Some farmers are considering reducing stocking rates in order to eliminate or drastically reduce the need for supplementary feed inputs. Farmers have also reportedly cut the number of carryover cows (cows not in calf at the end of the spring mating season) to a bare minimum.

Fertilizer sales, as reported by the two major fertilizer cooperatives, have fallen 25% to 30% in the last year. While this has the potential to negatively impact on production, it is too early to conclude that pasture production will be affected, especially in the short term. Over the last five to ten years, many farmers have fertilized at high levels and have high levels of macro-elements in the soil (P, K, S). In the current economic environment, pasture utilization is receiving increased attention. According to Dairy NZ, an industry

organization, farmers could lift production by 10% through better pasture allocation and utilization. The 680 cow dairy farm at Lincoln University on the South Island, which focuses on minimal supplement usage and strong pasture management, is one of the most highly profitable farms in the country (both in high and low payout years). Several farms in the Canterbury region of the South Island have followed Lincoln's lead and have matched or surpassed its success.

On balance, a good climatic start to the season coupled with better pasture utilization is expected to outweigh reduced fertilizer usage and any stocking rate declines.



Source: DairyNZ, LIC

Fonterra boosted its forecast payout to farmers for the coming season to NZ $5.10 per kilogram of milk solids from NZ $4.55 per kilogram, its initial forecast earlier in the year, reflecting the upturn in commodity prices. However, gains in commodity prices have been offset to some extent by a stronger kiwi dollar.

MY 2010/11 and Beyond

Over the longer term, there is potential for fluid milk production to expand further with the number of cows likely to top out at five million over the next ten to fifteen years. While land is still available for additional farm conversions, a key determining factor will be profitability along with other factors that could temper production including climate change policy and water issues.

New Zealand passed the Climate Change Response (Emissions Trading) Amendment Act in September 2008. Instead of capping the emissions of industry, the system required the sectors of the economy that produce greenhouse gasses to purchase "emission units" for each ton of gas produced. This not only gave New Zealand the distinction of being the only country in the world to include agriculture in a domestic emissions trading

scheme but also raised concerns that the resulting increase in on-farm costs would put the New Zealand agricultural sector at a competitive disadvantage.

In response to these and other concerns, the newly elected National-led Government established a select committee to review and consider changes to the ETS. Fonterra reportedly told the committee that New Zealand's dairy production could fall by 5%, costing the economy NZ $650 million annually unless the ETS were changed; and, expressed concern that its international competitiveness would be compromised if the dairy sector were exposed to an emissions price before its international competitors, especially without adequate mitigation tools. Fonterra reportedly argued for the agricultural component of the ETS to be based on an intensity measurement of emissions rather than the absolute total of emissions.

In September 2009, the Government introduced a bill to amend the ETS. Among other things, the proposed bill revises the entry date for agriculture, which is the single largest source of emissions in New Zealand, to 2015 and specifies a production-based industry average approach. Emissions from agriculture mainly consist of methane from livestock and nitrous oxide from animal excrement and the use of nitrogen fertilizer.

The changes proposed in the bill will make many of the elements of the New Zealand Emissions Trading Scheme consistent with the proposed Australian Carbon Pollution Reduction Scheme (CPRS), including the method of providing free allocations for emissions-intensive activities. The ETS will also feature a transitional phase that puts a NZ $25 fixed price carbon until January 1, 2013. This is similar to the price controls that will be in place in Australia.

Australia introduced bills to enact the Carbon Pollution Reduction Scheme (CPRS) to Parliament in June 2009. The CPRS is scheduled to begin in July 2011 with a $10 fixed price period followed by full trading on July 1, 2012.

Along with climate change, the Ministry of Agriculture has identified water quality management and water availability as important policy issues with significant implications for New Zealand agriculture. Tourism, along with agriculture, is a major driver of the New Zealand economy. However, expansion of the dairy industry and more intensive agricultural production are threatening New Zealand's clean and green image. Increased dairy production, especially on the South Island, has resulted in a sharp increase in irrigation over the past several years and agriculture now accounts for approximately 70% to 75% of the total mount of water used in New Zealand. The use of nitrogen fertilizer to maintain good pasture growth and achieve productivity gains has increased significantly in the past two decades. This, combined with increased animal waste from higher stocking rates, has negatively impacted on water quality. According to recent reports, nearly one-fifth of the groundwater monitored in New Zealand is too contaminated to drink. While there are many factors accounting for this, many point the finger at more intensive farming and the growth in the dairy sector.

To address water quality issues, farmers are upgrading effluent systems and monitoring nitrate leaching. ("Overseer" software is used on most farms now.) Mitigation initiatives include: altering the timing and rate of fertilizer and effluent applications; nitrogen inhibitors; waterways being fenced off and riparian planting; standoff pads and grazing off to reduce winter loading of the soil.

New Zealand has a maritime climate with significant amounts of rainfall but most of it flows out to sea. Water storage is seen as an important step to increasing productivity and the Minister of Agriculture, David Carter, recently stated that the government would not rule out funding for water storage proposals.

Water and environmental issues aside, if farmers adopted better grazing management techniques, many in the industry believe that national production could expand by up to 20% over the next ten to fifteen years. This could put total fluid milk production in a range between 18.5 and 20.5 million tons.

Whole Milk Powder Production

Whole milk powder (WMP) production for MY 2008/09 is estimated at 754,000 tons, up 16% over last year. In MY 2009/2010, if all of the increase in fluid milk production goes into WMP, production could reach 800,000 tons. This would be considerably higher than the average annual increase over the last fifteen years of roughly 28,000 to 30,000 tons per year.

For most processors in New Zealand, WMP is still the most profitable commodity to produce and virtually all of the additional processing capacity added over the last five years has been in the form of powder/drier facilities.

Skim Milk Powder Production

Skim milk powder (SMP) production jumped an estimated 36% to 361,000 tons in MY 2008/09. SMP production is expected to fall to 295,000 tons in MY 2009/10 as WMP prices improve and demand strengthens.

Cheese Production

Cheese production is estimated at 300,000 tons in MY 2008/09 and inventory is estimated at 55,000 tons. Cheese production is forecast to remain stable through MY 2009/10.

Butter Production

Total butter production is estimated at 428,000 tons in MY 2008/09, up 2% from last year. (AMF is multiplied by 1.22 to achieve butter equivalents in the PSD table.)

Overview of Processing Capacity in New Zealand

Over the last few years, several new processors have set up shop in New Zealand. Under the Dairy Industry Restructuring Act, these processors are eligible to obtain up to 50 million liters of regulated milk at a set price from Fonterra.

The two newest entrants, both of which are still in the development stage, are Mataura Valley Milk and Oceania Milk (formerly New Zealand Milk). Mataura Valley Milk has recently undergone a change of ownership and is reportedly planning to start operations in 2011/12. Oceania Milk is reportedly planning to commence operations in 2011 or 2012.

In MY 2008/09, Fonterra processed 1,281 million kilograms of milk solids or 91.83% of the total processed in New Zealand. As required by the Dairy Industry Restructuring Act, Fonterra supplied 441 million liters of regulated milk to other processors.

New Zealand: Overview of Dairy Processors (other than Fonterra)						
Company Name	**Date Established**	**Company Type**	**Estimated Total Milk Processed 2009/10 Season** 1/	**Estimated Milk Accessed under DIRA 2009/10 Season**	**Estimated Milk Processed 2012/13 Season**	**Product Focus**
			Millions of kilograms of milk solids			
North Island						
NZ Organic Dairy Farmers Coop	2008	Cooperative	2	0	6	Cheese
Tatua	1919	Cooperative	16.5	4.2	18	Caseinates, AMF, Specialty Products
Goodman Fielder		Corporate	20	20	20	Yogurt and Fluid Milk
Open Country Dairy	2007	Corporate	50	4.2	65	Cheese, Whey (low protein), WMP, SMP, AMF
Arapuni Milk Coy	Planning Capital Raising	Corporate	0	0	17	WMP
Total N.I			**88.5**	**28.4**	**126**	
South Island						
Westland Milk Products	1937	Cooperative	46	0	50	Milk Powder, Butter, AMF, Caseins, Caseinates etc.
Open Country Dairy	2007	Corporate	17	0	17	Cheese, Whey (low protein), WMP, SMP, AMF
NZ Dairies	2007	Corporate	18	3	18	WMP and Child Nutrition Products
Synlait	2008	Corporate	26	4.2	43	WMP, AMF, SMP and Nutritional Products
Mataura Valley Milk	In process of raising capital	Corporate	0	0	17	WMP
Oceania Milk	In process of raising capital	Corporate	0	0	17	WMP
Total S.I.			**107**	**7.2**	**162**	
Total NZ			**195.5**	**35.6**	**288**	

Sources: Press reports; Agricultural Affairs Office estimates

1/ Includes 35.6 million kilograms of milk obtained from Fonterra under the Dairy Industry Restructuring Act. Terms for Goodman Fielder are different from those of other companies. Note: To convert from millions of kilograms of milk solids to liters, multiply by 11.56

TRADE

Overview

Despite a 16.2% fall in the value of dairy product exports in MY 2008/09 to US $6.2 billion, the dairy industry is still New Zealand's top export earner accounting for approximately 23% of total merchandise exports. On a volume basis (excluding liquid milk), exports were up 6.8% from 1.74 million tons to 1.86 million tons. Liquid milk exports were up 11.4% from 89 to 99 million liters.

Major New Zealand Dairy Exports (MY 2008/09; Tons)	
Whole Milk Powder	663,725
Skim Milk Powder	309,720
Butter & Fat Products	377,162
Cheese	269,626
Casein, Caseinates, Milk Albumin and Whey Protein	89,891
Milk Protein Concentrates	77,082

Source: GTA

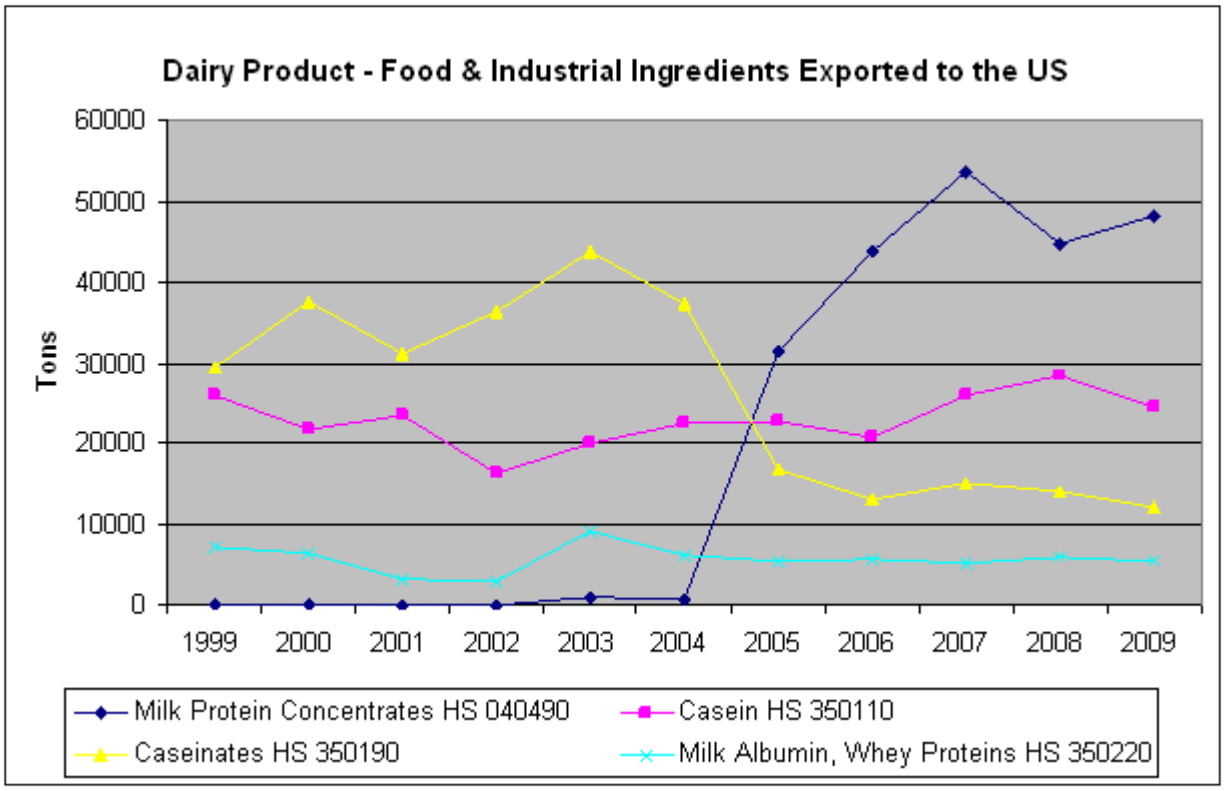
New Zealand Leading Dairy Export Markets (MY 2008/09; US Million Dollars)	
United States	735
China	484
Japan	432
Indonesia	307
Venezuela	294

Source: GTA

The United States continues to be New Zealand's largest market for dairy products accounting for 12% of total exports on a value basis in MY 2008/09. However, New Zealand's dairy exports to China surged in MY 2008/09, up 45%, to US $484 million from US $333 million last year. Leading exports to China include whole milk powder (WMP), up 75%, and skim milk powder (SMP), up 64%, in MY 2008/09. China now accounts for 8% of New Zealand's total dairy exports.

Total dairy exports to the U.S. market reached US $735 million in MY 2008/09, up from US $632 million the previous year. Leading exports on a value basis are milk protein concentrate (MPC) followed by casein, caseinates, cheese, and fats and oils. MPC exports were up 30% to US $249 million on volume increases of 3,250 tons. Cheese exports were up 56% to US $73 million on volume increases of 9,000 tons. Increases in the value of butter, anhydrous milkfat (AMF), and WMP exports made up the remainder of the increase.

The increase in exports to the United States and China offset a significant slump in exports to other top markets for New Zealand dairy products including Venezuela (-30%), Malaysia (-16%), Philippines (-34%), Australia (-23%) and Saudi Arabia (-39%).



Source: Global Trade Atlas

As described below, New Zealand's dairy exports are forecast to increase in MY 2009/10. While dairy commodity prices have strengthened in recent months, the strengthening New Zealand dollar will offset some of the benefits from higher export prices. The kiwi dollar, up nearly 30% from the beginning of the calendar year, tends to be more volatile than any other OECD currency.

Whole Milk Powder (WMP)

WMP exports reached 664,000 tons in MY 2008/09, up 7% but shy of the record 670,000 tons set in MY 2006/07. Exports were less than production estimates as approximately 90,000 tons of product was reportedly still on hand at the end of May waiting to be shipped.

China was the top export destination at 102,000 tons, up 188% from the previous year. Part of the explanation for the surge in WMP exports to China is the consumer backlash against domestic milk companies after the melamine contamination scandal in 2008.

The 2009/10 export season has gotten off to a strong start. During the first quarter, WMP exports were reportedly running 65,000 tons ahead of MY 2008/09. Exports are forecast to reach a record 810,000 tons in MY 2009/10, which reflects forecast production of 800,000 tons and a 10,000 ton decline in ending inventories as stocks are drawn down to reflect current demand and reduce working capital needs.

After hitting a low in July, WMP prices have bounced back significantly. In the October auction, average WMP prices were up 5.7% compared to the previous month at US $3,022 per ton. Whether or not this spells a recovery is uncertain. Some in the industry warn that the increase in prices predominantly reflects restocking of inventories rather than a sustainable increase in demand. For New Zealand, Chinese demand is likely to underpin MY 2009/10 WMP exports.

Skim Milk Powder (SMP)

Total SMP exports were up 23% in MY 2008/09 to 309,720 tons with exports to China surging 171% to 34,621 tons. The increase reflects a move by processors to produce more SMP and butter late last year when demand was weak and inventories were accumulating. (SMP and butter can be stored for longer than WMP.) Outside of the peak production months of October and November when there is spare capacity, Fonterra has the flexibility to alter production of various commodities to exploit short term price advantages, especially in major producing regions such as the Waikato on the North Island where transportation costs are relatively low.

SMP exports in MY 2009/10 are forecast to reach 324,000 tons. While production of SMP is forecast to fall to 295,000 tons in the face of improving WMP prices, the increase in exports reflects a build up of inventories that are expected to be drawn down during MY 2009/10.

Cheese

Over the last two years, cheese exports have fallen by 13% to 269,624 tons in MY 2008/09. Japan is the top export market for cheese taking 49,541 tons in MY 2008/09, although this was a 22% drop from MY 2007/08. The downturn was offset by a 49% rebound in cheese exports to the United States, the third largest market for New Zealand cheese, and a 43% increase to the United Kingdom, the sixth largest market.

Post forecasts cheese production to reach 300,000 tons in MY 2009/10 and exports are forecast at 292,000 tons. Exports for the first three months of the year are up 11,000 tons compared to the same period last year. Once the quota markets are filled the total amount of cheese produced will depend on relative pricing of other dairy commodities.

Butter and Fat Products

Butter and dairy fat exports rebounded in MY 2008/09, up 9%, reaching 377,162 tons. *(Note: This figure is not adjusted for PSD corrections.)* On a butter equivalent basis, export tonnage is estimated at 407,000 tons, a 10% increase. Iran emerged as the leading export destination for New Zealand dairy fat products at 36,255 tons followed by Egypt at 31,864 tons and Belgium at 28,582 tons (although this is likely to be a transshipment entry point to the EU).

Post forecasts fat and butter production to fall slightly to 412,000 tons in MY 2009/10. Export levels are forecast to remain stable at 406,000 tons as the build up in inventory levels is drawn down.

In the wake of the late monsoon season in India, AMF exports have increased and India is now New Zealand's eight largest export destination by volume for fat products.

Trade and Government Policy

New Zealand Busy Negotiating FTAs

New Zealand is an active participant in the flood of free trade agreements (FTAs) in the Asia region. Agreements include a China FTA implemented on October 1, 2008; an FTA between ten ASEAN countries, Australia and NZ that will be implemented next year; and an FTA with Malaysia that was concluded in June and expected to be ratified later this year. New Zealand has also completed two rounds of negotiation towards a NZ-Korea FTA.

China is New Zealand's fourth largest agricultural market behind the United States, Australia and Japan. Whole milk powder is New Zealand's leading agricultural export to China accounting for approximately 16% of total agricultural exports in CY 2008. The FTA will eliminate tariffs on 96% of New Zealand's exports to China, including milk powder. Under the agreement, tariffs on milk powder will be phased out over 12 years from the current base rate of 10% and eliminated in 2019. Tariffs on cheese, butter and liquid milk will be phased out over ten years. The agreement contains a temporary special safeguard mechanism, which was triggered earlier this year by the surge in dairy exports from New Zealand. As a result, the New Zealand preferential tariff rate has reverted to the MFN rate for three of the four special safeguard categories. Liquid milk and cream reached the trigger amount of 1,365 tons in April and the tariff snapped back from 12% to 15%. Butter followed suit in July reaching a trigger of 9,870 tons and the tariff reverted from 8% to 10%. Powders reached the 99,750 ton trigger in August and the tariff was increased from 8.3% to 10%. So far this calendar year, the cheese trigger (3,780 tons) has not been met. Since 2000, New Zealand's total dairy exports to China have jumped from US $63 million in CY 2000 to US $373 million in CY 2008. China accounted for approximately 5% of total New Zealand dairy exports in CY 2008, up from approximately 2% in CY 2000.

Overall, New Zealand dairy exports to China reached a record US $531 million during the first eight months of the calendar year – a 52% increase over the same period last year. Exports of whole milk powder more than doubled during the same period reaching US$ 302 million. Skim milk powder exports jumped from US $60.3 to US $83.4 million.

The ASEAN, Australia, New Zealand Free Trade Area (AANZFTA) Agreement will eliminate tariffs on almost all of New Zealand's exports to ASEAN countries, including dairy products. Tariffs will be eliminated at various stages between 2010 and 2020. For example, tariffs on whole milk powder, butter and cheese exports to Indonesia, and tariffs on exports of casein, milk powder, cheese, and butter milk to the Philippines will be eliminated in 2010. All of these products currently face tariffs of 5%. Examples of products with later elimination dates include unsweetened skim milk powder in Indonesia; casein, butter milk and butter oil in Vietnam; and, liquid milk, butter and some cheese in the Philippines. While New Zealand dairy exports to ASEAN countries have expanded significantly, up from US $470m in MY 2000 to US $1.3 billion in MY 2009, having peaked in MY2008 at US $1.7bn. The ASEAN region as a percentage of NZ's total dairy exports accounted for 21% of total dairy exports in MY2009 very similar to the 20% in MY 2000.

Malaysia is New Zealand's seventh largest market for dairy products on a value basis – taking US $370 million or 5% of total dairy exports in CY 2008. While the details of the agreement haven't yet been made public, the benefits secured through the Malaysia FTA are reportedly additional to those won under the recently signed AANZFTA. Although there is no duty on milk powder, duties of between 5-10% are levied on butter and cheese imports. Importers of these products also require an import license.

Korea is New Zealand's sixth largest market. While only the 18th largest market for dairy products, the market has grown from US $42 million in CY 2000 to US $125 million in CY 2008. If successful, the FTA will remove high tariff barriers to trade (176% for powder, 36% for cheese).

MAF Announces New Formula for Pricing of Regulated Milk

The New Zealand Ministry of Agriculture (MAF) announced a new formula for pricing regulated milk under the Dairy Industry Structuring Act (DIRA). Under DIRA, Fonterra must supply up to 5% of its milk to competitors at a regulated price. Fonterra has long complained that the DIRA pricing formula under-prices milk thereby requiring it to supply its rivals at less than the farm gate price. Under the proposal, Fonterra would get an automatic premium of NZ ten cents per kilogram/milk solids for each liter of milk supplied (approximately 600 million liters per year).

Historical Difference between the Wholesale and Farm Gate Milk Price in New Zealand

Season	Wholesale price (kg/MS)	Farm gate price (kg/MS)	Difference (kg/MS)	Difference (per liter)
2003 / 2004	$3.82	$3.97	$0.15	$0.01
2004 / 2005	$4.27	$4.39	$0.12	$0.01
2005 / 2006	$3.55	$3.85	$0.30	$0.03
2006 / 2007	$3.91	$3.87	-$0.03	$0.00
2007 / 2008	$7.24	$7.55	$0.31	$0.03
2008 / 2009 (est.)	$4.67	$4.75	$0.08	$0.01

Source: MAF

This proposal stems from a review of the raw milk regulations initiated by MAF in August 2007. In a 2008 report to Cabinet, MAF agreed that the current default formula is pricing milk lower than Fonterra pays its own suppliers, and outlined five potential remedies including a recommended option of creating an auction system to be implemented in 2010/11. It is unclear at this point whether or not an auction system will be implemented but some speculate that this is a transitional step in the direction of an auction and the new price could act as a reserve price in an auction-based system.

DIRA was put in place when Fonterra was formed in 1991 through a merger of the Dairy Group, Kiwi Dairies and the single-desk exporter the NZ Dairy Board. At the time, there was political support for the merger as it was widely believed that consolidation would help New Zealand compete on the global dairy

market. However, the New Zealand Commerce Commission opposed the merger on competition grounds and DIRA was the suite of measures the New Zealand Government put in place to foster competition.

The basic premise of DIRA is open entry and exit. From an entry standpoint, this means that Fonterra, with some exceptions, must accept milk from potential suppliers. From an exit standpoint, producers must be able to easily redeem their shares if they want to leave Fonterra and supply another processor. DIRA requires Fonterra to reimburse producers who are exiting the coops within 30 days of the end of the production season.

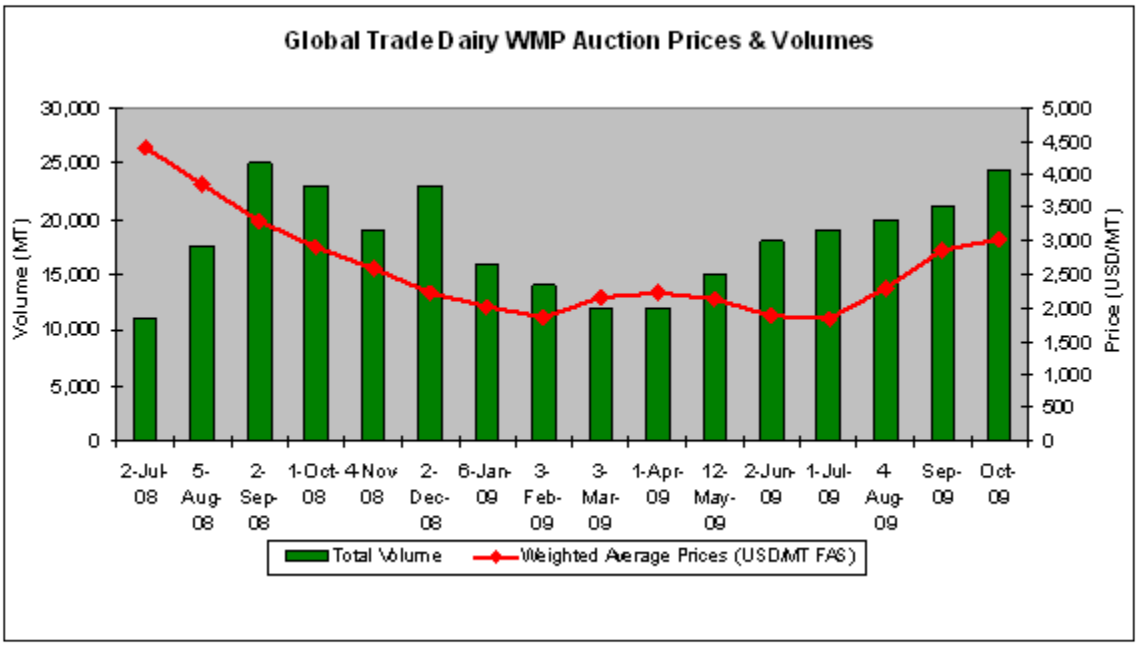
Share redemption has become a major issue for Fonterra and one of two primary factors that have driven the capital restructuring exercise. Some in the industry have expressed a concern that, if the restructuring makes it more difficult for suppliers to leave Fonterra, it will negatively impact on the growth of independent processors.

Marketing

Fonterra Expands Auction System

Fonterra implemented an internet-based auction platform for sales of whole milk powder in July 2008. Over the last three auctions, average prices have climbed 56% after hitting a low in July 2009.

Fonterra announced that AMF will be offered for the first time in the November 2009 auction.



Source: GlobalTrade dairy

Fonterra could start more dairy farms in China

Fonterra's joint venture dairy farm in Hebei Province, which was developed at an estimated cost of $20.7 million, reportedly has 4,500 cows, and, by this time next year, could have as many as 6,000 head. The Tangshan dairy operation is 85% owned by Fonterra. Fonterra accounted for 5% percent of China's dairy market last year, and combined sales of foreign imported dairy products comprised about 12% of the total domestic market.

PSD Tables

Dairy, Milk, Fluid NewZealand	2008 Market Year Begin: Jun 2007			2009 Market Year Begin: Jun 2008			2010 Market Year Begin: Jun 2009		
(1000 Hd, 1000MT)	Official Data	Post Estimate	New Post Data	Official Data	Post Estimate	New Post Data	Official Data	Post Estimate	New Post Data
Cows In Milk	4200	4200	4200	4365	4365	4365			4470
Cows Milk Production	15141	15141	15141	16400	16400	16601			17021
Other Milk Production	0	0	0	0	0	0			0
Total Production	15141	15141	15141	16400	16400	16601			17021
Other Imports	0	0		1	0	2			2
Total Imports	0	0		1	0	2			2
Total Supply	15141	15141	15141	16401	16400	16603			17023
Other Exports	92	92	92	110	109	102			112
Total Exports	92	92	92	110	110	102			112
Fluid Use Dom. Cons.	345	345	345	331	331	331			340
Factory Use Consum.	14659	14659	14659	15915	15915	16125			16526
Feed Use Dom. Cons.	45	45	45	45	45	45			45
Total Dom. Cons.	15049	15049	15049	16291	16291	16501			16911
Total Distribution	15141	15141	15141	16401	16401	16603			17023
CY Imp. from U.S.	0	0	0	0	0	0			0
CY. Exp. to U.S.	0	0	0	0	0	0			0
TS=TD			0			0			0

Dairy, Dry Whole Milk Powder New Zealand (1000 MT)	2008 Market Year Begin: Jun 2007			2009 Market Year Begin: Jun 2008			2010 Market Year Begin: Jun 2009		
	Official Data	Post Estimate	New Post Data	Official Data	Post Estimate	New Post Data	Official Data	Post Estimate	New Post Data
Beginning Stocks	22	40	40	52	70	70			160
Production	651	651	651	710	710	754			800
Other Imports	1	1	1	1	1	1			1
Total Imports	1	1	1	1	1	1			1
Total Supply	674	692	692	763	781	825			961
Other Exports	621	621	621	664	700	664			810
Total Exports	621	621	621	664	700	664			810
Human Dom. Cons.	1	1	1	1	1	1			1
Other Use, Losses	0	0		0	0	0			0
Total Dom. Cons.	1	1	1	1	1	1			1
Total Use	622	622	622	665	701	665			811
Ending Stocks	52	70	70	98	80	160			150
Total Distribution	674	692	692	763	781	825			961
CY Imp. from U.S.	0	0	0	0	0	0			0
CY. Exp. to U.S.	1	1	1	1	1	2			1
TS=TD		0	0		0	0			0

Dairy, Milk, Nonfat Dry New Zealand (1000 MT)	2008 Market Year Begin: Jun 2007			2009 Market Year Begin: Jun 2008			2010 Market Year Begin: Jun 2009		
	Official Data	Post Estimate	New Post Data	Official Data	Post Estimate	New Post Data	Official Data	Post Estimate	New Post Data
Beginning Stocks	8	20	20	20	34	34			85
Production	265	265	265	310	290	361			295
Other Imports	1	1	1	1	1	1			1
Total Imports	1	1	1	1	1	1			1
Total Supply	274	286	286	331	325	396			381
Other Exports	251	251	251	310	288	310			324
Total Exports	251	251	251	310	288	310			324
Human Dom. Cons.	3	1	1	3	1	1			1
Other Use, Losses	0	0	0	1	1	0			1
Total Dom. Cons.	3	1	1	4	2	1			2
Total Use	254	252	252	314	290	311			326
Ending Stocks	20	34	34	17	35	85			55
Total Distribution	274	286	286	331	325	396			381
CY Imp. from U.S.	0	0	0	0	0	0			0
CY. Exp. to U.S.	0	0	0	0	0	0			0
TS=TD			0		0	0			0

Dairy, Cheese New Zealand	2008			2009			2010		
	Market Year Begin: Jun 2007			Market Year Begin: Jun 2008			Market Year Begin: Jun 2009		
(1000 MT)	Official Data	Post Estimate	New Post Data	Official Data	Post Estimate	New Post Data	Official Data	Post Estimate	New Post Data
Beginning Stocks	6	20	20	15	33	41			55
Production	314	314	320	345	345	300			300
Other Imports	6	6	6	6	6	4			6
Total Imports	6	6	6	6	6	4			6
Total Supply	326	340	346	366	384	345			361
Other Exports	283	283	283	270	325	270			314
Total Exports	283	283	283	270	325	270			292
Human Dom. Cons.	28	24	22	28	24	20			24
Other Use, Losses	0	0	0	0	0	0			0
Total Dom. Cons.	28	24	22	28	24	20			24
Total Use	311	307	305	298	349	290			316
Ending Stocks	15	33	41	68	35	55			45
Total Distribution	326	340	346	366	384	345			361
CY Imp. from U.S.	0	0		0	0	0			0
CY. Exp. to U.S.	30	19	19	19	23	28			25
TS=TD		0	0		0	0			0

Dairy, Butter New Zealand	2008			2009			2010		
	Market Year Begin: Jun 2007			Market Year Begin: Jun 2008			Market Year Begin: Jun 2009		
(1000 MT)	Official Data	Post Estimate	New Post Data	Official Data	Post Estimate	New Post Data	Official Data	Post Estimate	New Post Data
Beginning Stocks	15	40	40	15	43	70			75
Production	391	391	420	430	405	428			412
Other Imports	2	2	2	2	2	4			2
Total Imports	2	2	2	2	2	4			2
Total Supply	408	433	462	447	450	502			489
Other Exports	367	367	369	405	382	407			406
Total Exports	367	367	369	405	382	407			406
Domestic Cons.	26	23	23	26	23	20			23
Total Use	393	390	392	431	405	427			429
Ending Stocks	15	43	70	16	45	75			60
Total Distribution	408	433	462	447	450	502			489
CY Imp. from U.S.	0	1	0	0	1	0			0
CY. Exp. to U.S.	18	22	22	22	25	30			27
TS=TD			0		0	0			0

Environmental Issues

Fonterra Completes Carbon Footprint Study

In June, Fonterra announced the results of an 18-month study to measure its carbon footprint. Key findings were that the carbon footprint is 940 grams of CO2 equivalent per liter of liquid milk; around 85% of greenhouse gases are emitted on the farm (59% of these are methane, 17% are carbon dioxide, and 24% are nitrous oxide); and, processing/manufacturing accounts for 10% of total emissions while distribution accounts for 5%. The results were calculated by measuring carbon emissions through each stage of the product life cycle – from on-farm where raw milk is produced to the finished commodity leaving New Zealand and being transported to overseas markets.

The Netherlands, Scandinavia and Germany have reportedly done studies similar to what Fonterra did but used a different methodology. Fonterra is actively working with key international dairy organizations and producers to get an agreed carbon footprint measuring methodology in place.

Virtual Water a Potential Concern

Following on the heels of food miles and carbon foot printing, the concept of "virtual water" is beginning to capture the attention of journalists, policy makers, and industry players in New Zealand. According to press reports, it is estimated that New Zealand exports 500 million cubic meters of water. However, unlike food miles, where New Zealand is at a relative disadvantage given the distance from most markets, New Zealand has a "water stress index" of just 0.8%. Other countries reportedly export the same amount of water but have a much higher water stress index.

New Zealand has a maritime climate with lots of rain. However, irrigation for agriculture reportedly accounts for as much as 70% to 75% of total water consumption, which is relatively high.

Use of Palm Kernel Extract (PKE) Controversial

Use of palm kernel extract (PKE), a by-product of palm oil production, has become controversial in New Zealand. The popular press has associated PKE usage with rainforest and animal habitat destruction in Southeast Asia. Some have also expressed biosecurity concerns. Dairy farmers use it as a relatively inexpensive feed supplement and imports have skyrocketed reaching a peak of one million tons in 2008. Imports are expected to fall to between 600,000 and 700,000 tons in 2009 in view of the current on-farm economic climate.

Research and Development

New Zealand Government Launches Food Innovation New Zealand

In August 2009, Prime Minister John Key officially launched Food Innovation New Zealand (FINZ). Based at Massey University in Palmerston North, FINZ is aimed at increasing New Zealand's capacity in food innovation enabling the industry to better perform in domestic and international markets. Central to the initiative is collaboration among research and industry leaders including AgResearch, Plant and Food Research, Fonterra, the Bio Commerce Centre, and the Riddet Institute (a Government-funded research center at Massey University).

Massey University has also announced an agreement with Wageningen University in The Netherlands to partner on research with the aim of increasing global food production.

Other Issues

Fonterra Announces Plan for Capital Restructuring

Fonterra, the world's largest dairy processor and New Zealand's largest company, announced a capital restructuring proposal on September 18, 2009. This is Fonterra's second attempt at a capital restructure and is intended to raise some of the capital needed to finance its global expansion objectives.

Under the current proposal, farmer shareholders will be able to purchase additional shares up to 120% of their expected milk production. The additional 20% will be in the form of "dry" shares that will pay a dividend to producers. In addition, Fonterra will change the share valuation approach to reflect the fact that shares cannot be freely bought or sold on an open market. This is intended to minimize share price volatility and will result in a lower share value. Speculation is that the value of shares will fall 10-30% from current levels. If steps one and two are supported by producers at the November 18 annual meeting, Fonterra will create a new share market system, which means that Fonterra would no longer have to purchase shares from suppliers who exit the industry. Instead, farmers could sell their shares to other farmers through the share market system. This would minimize Fonterra's redemption risk and improve their balance sheet by reducing liabilities. Depending on the progress in implementing steps one and two, the new share market system could potentially be implemented in 2010. It would require a legislative change to the Dairy Industry Restructuring Act.